

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 18576
[Redacted],)	
)	DECISION
Petitioners.)	
_____)	

On December 1, 2004, the staff of the Income Tax Audit Bureau of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (taxpayers), proposing income tax, penalty, and interest for the taxable years 2000 through 2002 in the total amount of \$586,904.

On January 31, 2005, the taxpayers filed a timely appeal and petition for redetermination. The taxpayers requested a hearing which was held at the Tax Commission's office in Boise on September 9, 2005. The Tax Commission, having reviewed the file, hereby issues its decision.

The taxpayers are shareholders of an S-Corporation that conducts business in most of the states of the United States and several foreign countries. The taxpayers claimed on their Idaho individual income tax returns a credit for taxes paid to other states as a result of the S-Corporation's business activities. The Income Tax Audit Bureau (Bureau) selected the taxpayers' timely filed 2000, 2001, and 2002 returns to review the amount claimed as a credit for taxes paid to another state (credit). The Bureau completed its review of the credit and determined the credit needed adjustment to be in compliance with Idaho Code section 63-3029 and Income Tax Administrative Rule IDAPA 35.01.01.700. The Bureau corrected the taxpayers' Idaho income tax returns and sent them a Notice of Deficiency Determination.

The taxpayers protested the Bureau's determination. The taxpayers disagreed with the Bureau's interpretation of Idaho Code section 63-3029(3) and the resulting computation of the credit. The taxpayers disagreed with the application of Rule 700.04 because rounding was for

convenience, and it resulted in an inaccurate tax liability for the taxpayers. The taxpayers also contested the imposition of the penalties to the Notice of Deficiency Determination.

The matter was referred for administrative review, and the Tax Commission sent the taxpayers a letter giving them two options for having the Notice of Deficiency Determination redetermined. As mentioned, the taxpayers requested a hearing which was attended by the taxpayers' representative, [Redacted], C.P.A.; Commissioner [Redacted]. Mr. [Redacted] presented the taxpayers' position. Regarding the rounding issue of Rule 700.04, Mr. [Redacted] stated that, although the administrative rule is quite clear, rounding to the nearest percent, in this case, makes a substantial difference in the amount of credit allowed. The taxpayers had substantial income, and they paid thousands of dollars in tax to other states. However, the proportionate share of income in some of the states was small in comparison to the total income. The resulting percentage was less than one-half a percent and with the Tax Commission's rounding policy the taxpayers got no credit even though they paid several thousand dollars in tax to the other state. Mr. [Redacted] stated the taxpayers were being penalized for being accurate.

In addition to rounding the percentage, Mr. [Redacted] stated the taxpayers disagreed with the method the Bureau used to calculate the credit. Specifically, the taxpayers disagree with the Bureau's interpretation of Idaho Code section 63-3029(3). Mr. [Redacted] stated the Bureau's calculation recalculates the business income of the taxpayers' S-Corporation for each of the states in which the S-Corporation does business. The Bureau's calculation adjusts the business income reported to the other state in terms of the Idaho Income Tax Act. Mr. [Redacted] stated the credit computation was not intended to modify business income. It is solely an individual credit and should only modify the adjusted gross income of the individual. Mr. [Redacted] said the Bureau's method would make it very difficult for a taxpayer and the practicing community to

compute. Most taxpayers do not have access to the information required to do the computation and the time requirement for the professionals in a case like this would be cost prohibitive. Furthermore, the administrative burden on accounting firms would be enormous.

Lastly, Mr. [Redacted] asked that the penalties be waived because the taxpayers made a good faith attempt to comply with the law in the proper and most accurate means possible. He also asked that they be given guidance so they would know how to deal with this issue in the future.

Idaho Code section 63-3029 subparts (1) and (3) state,

(1) A resident individual shall be allowed a credit against the tax otherwise due under this chapter for the amount of any income tax imposed on the individual, an S corporation, partnership, limited liability company, or trust of which the individual is a shareholder, partner, member, or beneficiary (to the extent attributable to the individual as a result of the individual's share of the S corporation's, partnership's, limited liability company's or trust's taxable income in another state), for the taxable year by another state on income derived from sources therein while domiciled in Idaho and that is also subject to tax under this chapter.

(3) The credit provided under this section shall not exceed the proportion of the tax otherwise due under this chapter that the amount of the adjusted gross income of the taxpayer derived from sources in the other state as modified by this chapter bears to the adjusted gross income of the taxpayer as modified by this chapter. This limitation applies to all individuals whether the tax paid to the other state is paid by the individual or by an S corporation, partnership, limited liability company, or trust. Further, the credit shall not exceed the tax paid to the other state.

Subsection (1) provides that the credit is available to resident individuals on their Idaho individual income tax return. It also provides that the credit be computed for income that is taxed by another state as a result of the activities of a flow-through entity (S-Corporations, partnerships, LLCs, or trusts).

Subsection (3) provides for a limitation of the credit. The limitation is determined by comparing the adjusted gross income from sources in the other state to adjusted gross income, both being modified by this chapter. The language "as modified by this chapter," is where the interpretation of the Bureau is questioned by the taxpayers. The Bureau has taken this language to mean that the other state's return, be it an individual return or a business return, be adjusted to conform to the Idaho income tax code. The Bureau's interpretation attempts to get the adjusted gross income from the other state on an equal basis as the adjusted gross income reported on the Idaho income tax return. To this end, the Bureau made adjustments that included charitable contributions claimed by the S-Corporation, bonus depreciation allowed in other states, exempt interest and dividends, taxable refunds of state and local taxes, changing the number of apportionment factors, extraterritorial income, state taxes not measured by income, additions and subtractions of ordinary net gains and losses, other income or losses not added or subtracted in Idaho's statutes, capital losses not included, net section 1231 losses, and changes to the apportionable income of the S-Corporation that are not part of Idaho law. These changes, the taxpayers believe, go beyond the intent and spirit of the law. They claim that this method of calculating the credit would place an undue burden on taxpayers and the tax preparation profession. They stated it was not the intent of Idaho Code section 63-3029(3) to require a recalculation of the corporate or partnership returns of every state, to reflect Idaho law, to calculate the credit.

For the interpretation of this section of the Idaho Code and specifically the phrase "as modified by this chapter," the Tax Commission would generally turn to the Income Tax Administrative Rules adopted by the Idaho legislature. However, in this instance there are no

rules that address Idaho Code section 63-3029(3). Therefore, the Tax Commission must look at the plain language of the statute.

The statute states that the credit, "shall not exceed the proportion of tax otherwise due under this chapter that the amount of the adjusted gross income of the taxpayer derived from sources in the other state as modified by this chapter bears to the adjusted gross income of the taxpayer as modified by this chapter." The term "chapter" is used three times in the first sentence of this subsection. Therefore, one would assume there is some significance placed on the use of that term. It is clear that chapter refers to how the Idaho Code is divided into titles and chapters. Title 63 is Revenue and Taxation and chapter 30 covers income tax. The sections are numbered in this manner, i.e. Title 63, Chapter 30, section 29, subpart (3); 63-3029(3). Therefore, when subpart (3) of section 29 of chapter 30 says "this chapter" it is referring to Chapter 30 – Income Tax. Since it is clear that "chapter" refers to chapter 30 – Income Tax, it should be easy to come to an understanding of the meaning of the phrase "as modified by this chapter."

The Idaho income tax computation for individuals begins with federal taxable income. Modifications are then made per the Idaho Income Tax Act to arrive at Idaho taxable income. Subpart (3) states that the adjusted gross income derived from sources in the other state be modified by this chapter. It seems clear then that "modified" refers to the modifications contained in chapter 30 and that those modifications are to be applied to the adjusted gross income derived from sources in the other state. Therefore, if the other state's adjusted gross income includes income that is exempt from Idaho taxation, a subtraction would be made to the other state's adjusted gross income in the calculation of the credit.

The taxpayers agree that the modifications apply at the individual level but disagree that the modifications should take place at the corporate or partnership level. The taxpayers do not believe their S-Corporation's returns, filed with the other states, should be modified to reflect Idaho statutes.

The Tax Commission believes the intent and purpose of the credit is to provide tax relief where resident taxpayers are required to file returns and pay taxes in other states on the same income taxed by Idaho. However, not all states tax the same income and some states base their tax on something other than income. The statute's use of adjusted gross income as modified by this chapter attempts to bring the various taxing schemes of the various states onto a level playing field. By modifying the other states' returns to reflect Idaho law, the proration percentage results in a more accurate comparison of the adjusted gross incomes. In some instances, the other states' tax also needs to be recalculated to reflect only the tax that was paid on income that is taxed by Idaho. (Idaho Code section 63-3029(1)) The end result is a credit allowed on the Idaho return that closely approximates the tax Idaho would have assessed on the double taxed income.

It follows then that if the intent of the law is to give the taxpayer a credit for the amount of tax that the taxpayer would pay had he paid the tax to Idaho, then the income the tax is based upon should be tallied in the manner prescribed by Idaho law. Therefore, the Tax Commission finds the proper determination of income to another state flowing through from a partnership, S-Corporation, or LLC for purposes of determining the credit available on the taxpayers' returns must be determined as provided for in the Idaho statutes. The Bureau's computation of the credit follows this methodology and is hereby upheld by the Tax Commission.

The next issue protested by the taxpayers was the Bureau's application of Income Tax Administrative Rule 700.04. The Rule states,

04. Rounding To The Nearest Whole Percent. The percentage calculated under Section 63-3029, Idaho Code, shall be rounded to the nearest whole percent. This percentage may not exceed one hundred percent (100%) nor be less than zero (0). For example, sixty-six and one-half percent (66.5%) shall be rounded to sixty-seven percent (67%). Sixty-six and four-tenths percent (66.4%) shall be rounded to sixty-six percent (66%).

The taxpayers stated that the rounding of the percentage is an administrative convenience, and it makes the reporting of their tax liability less accurate. They stated the rounded percentage in some states where they paid tax resulted in no credit because the percentage was less than one-half of a percent. The taxpayers stated rounding results in violation of the intended results and spirit of the law. In their case, the difference is in the tens of thousands of dollars.

The State Tax Commission is granted the authority to prescribe all needful rules and regulations for the enforcement of the Idaho Income Tax Act. (Idaho Code sections 63-105 and 63-3039.) The State Tax Commission deemed it necessary to require the rounding of numbers for certain computations. In addition to the rounding of the proration percentage in Rule 700.04, the State Tax Commission requires rounding to the nearest whole percent in Rule 255.02 – Nonresident and Part-year Resident Individuals – Proration of Exemptions and Deductions and Rule 450.03 the apportionment formula for the individual factors and the average factor for multi-state taxpayers. The Idaho Code, section 63-113, also provides that the State Tax Commission may require rounding to the nearest whole dollar any amount shown or required to be shown on any return, form, statement or other document submitted to the State Tax Commission.

Although this rule, as well as the rules mentioned above, could result in the taxpayers receiving less of a credit, it could also result in the taxpayers receiving a larger credit. Part of the

Tax Commission's charge is to enforce Idaho's income tax laws and to apply them consistently to all taxpayers. Although the effects of rounding will vary from taxpayer to taxpayer and from year to year for the same taxpayer, the Tax Commission finds no provision in the Income Tax Administrative Rules to deviate from the existing Rule of rounding to the nearest whole percent. If the Tax Commission disregarded the rule in this case, what message would be sent to the taxpayers of Idaho? Therefore, the Tax Commission upholds the Bureau's rounding of the proportion percentage.

The Bureau added interest and penalties to the taxpayers' tax deficiency. The Tax Commission reviewed those additions and found they were in accordance with Idaho Code sections 63-3045 and 63-3046, respectively. However, the Tax Commission found that the taxpayers had reasonable cause for their calculation of the credit and that they acted in good faith in trying to file an accurate return. Therefore, the Tax Commission waives the penalties added to the taxpayers' tax (Idaho Code section 63-3046(7)).

Prior to the completion of this administrative appeal, the taxpayers amended their returns for items unrelated to the credit but that did have an effect on the credit. The Tax Commission reviewed the amended returns and made the appropriate changes to the credit that were caused by the amended returns.

WHEREFORE, the Notice of Deficiency Determination dated December 1, 2004, is hereby MODIFIED, in accordance with the provisions of this decision and, as so modified, is APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayers pay the following tax, penalty, and interest:

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2000	\$162,102	-0-	\$51,743	\$213,845
2001	112,251	-0-	25,819	138,070
2002	170,558	-0-	30,325	<u>200,883</u>
			TOTAL	\$552,798
			REMITTANCE	<u>102,207</u>
			BALANCE DUE	\$450,591

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the taxpayers' right to appeal this decision is included with this decision.

DATED this ____ day of _____, 2006.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2006, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]
[Redacted]

Receipt No.
Receipt No.